BRIEF IN SUPPORT OF PETITION.

JURISDICTION.

Opinion Below The opinion of the Appellate Court of Illinois for the First District was rendered January 20, 1941. The rehearing was denied February 5, 1941 and the opinion is published (308 Ill. App. page 78). The Supreme Court denied leave to appeal April 10, 1941 without any opinion.

Jurisdiction Invoked The statutory provision under which the jurisdiction is invoked is under Section 237b of the Judicial Code as Amended by the Act of February 13, 1925, 43 Stat. 936, 937 (28 U. S. C. A. Sec. 344b).

The Federal question was raised defensively by the plea of *res adjudicata* based on 77B proceedings (R. 23). The question was decided for the first time on review when the Appellate Court sustained this defense, which was not sustained below. The Federal question was also raised by the Petition for Rehearing.

Authorities to Sustain Jurisdiction The authorities believed to sustain the jurisdiction are as follows:

(a) The Decision of the Appellate Court Made Final by the Denial of Leave to Appeal Is Subject to Review Here on Certiorari.

Minneapolis & St. Paul, et al. v. *Rock*, 279 U. S. 410.

Pennsylvania R. Co. v. *Illinois Brick Co.*, 297 U. S. 447.

(b) The Order Sustaining the Defense of Res Adjudicata Based on the 77B Proceedings Brings This Case Within Section 237b for Review by Certiorari.

Cumberland Glass Co. v. *De Witt,* 237 U. S. 447.

Indiana v. *Brand,* 303 U. S. 95.

We quote the following from the *Cumberland* case *supra* (p. 449):

> "The Federal question, which is the basis of jurisdiction here, arises upon the plea of *res adjudicata* to which a demurrer was sustained in the Maryland court of original jurisdiction which judgment was affirmed by the Court of Appeals. *This presents a Federal question* because the plea of former judgment in a Federal court adjudicating a right of Federal origin, asserts a right which if denied made the case reviewable here under Sec. 709, Revised Statutes, Sec. 237, Judicial Code. *Deposit Bank* v. *Frankfort,* 191 U. S. 499."

See also Robertson & Kirkham on Jurisdiction of the Supreme Court, page 28, Section 15, Note 12, citing *Nutt* v. *Knut,* 200 U. S. 12, on the proposition that *the Federal question may be raised defensively.*

(c) The Action of the Court in Sustaining the Defense of Res Adjudicata Based on the 77B Proceedings Raised a Federal Question As a Denial of Due Process Under the Fourteenth Amendment.

Simon v. *Southern Railway,* 236 U. S. 115.

Hansberry v. *Lee,* 311 U. S. 32.

(d) The Federal Question Was Properly and Timely Raised.

No particular words are necessary to raise the Federal question and the question is sufficiently raised if it appears from the nature of the pleadings that a Federal right was before the court for a decision (*St. Louis et al.* v. *Starbird*, 243 U. S. 592, 597).

Petitioner did not anticipate that the Appellate Court would sustain the defense of *res adjudicata* as this defense was not sustained below and the question which was first presented by the decision was *timely* raised by the Petition for Rehearing (*Saunders* v. *Straus*, 244 U. S. 317; *Henderson* v. *Georgia*, 295 U. S. 441, 444). The question was also raised below *defensively* by the answer and reply (R. 23). The petition for rehearing stated (see page 31, *infra*):

> "On the question of *res adjudicata* it should be noted that *this defense was not sustained by the trial court.* A dismissal of a complaint for want of equity does not embrace a plea of *res adjudicata.* The reason why the lower court did not sustain it is apparent from the position taken by the defendants in the United States Circuit Court of Appeals where *they contended that the proceedings there can under no sense be pleaded as res adjudicata to the accounting against the trustees* (Abst. 46, 47). The entire argument in our brief (pp. 35-45) on the question of *res adjudicata was wholly overlooked* by this court. In sustaining the plea of *res adjudicata* this court deprived the plaintiffs of their property without due process of law in contravention of the Fifth and Fourteenth Amendments to the Federal Constitution. (*Cumberland Glass Co.* v. *DeWitt*, 237 U. S. 447; *Hansberry* v. *Lee*, 85 L. Ed. p. 11.)"

STATEMENT OF THE CASE.

The facts as stated in the Petition are deemed to be sufficient for the Statement of the Case without any further statement. It is necessary, however, to give a more detailed statement of the proceedings culminating in the confirmation of the Reorganization Plan which were pleaded as *res adjudicata* to this suit.

This was the first case which presented the question to this court whether superior rights of bondholders may be given to junior interests without consideration, as part of a Reorganization Plan under Section 77B. The Federal Courts then held the view that under Section 77B, when the required number of creditors were satisfied to give up part of their security in favor of junior creditors, the courts had to approve such plans. NETTIE MEYER, the original plaintiff in this suit, who was restrained by the 77B proceedings, filed her petition in the Reorganization Proceedings attacking the good faith of the Petition and asked its dismissal and the dissolution of the restraining order. This was denied and she prosecuted an appeal to the Seventh Circuit. During the pendency of the appeal (which did not operate as a supersedeas) the District Court heard objections to the Plan filed by the other petitioners and approved the Plan with modifications, but allowed 10 per cent interest to "Straus" for its junior equity. Petitioners asked leave from the Seventh Circuit to appeal under 24b and also filed an appeal under 24a from the approval of the Plan. The Seventh Circuit held that the appeal taken by NETTIE MEYER was improperly taken under 24a and dismissed that appeal (77 Fed. (2d) 1004). It refused to grant leave to appeal from the approval of the Plan under 24b and dismissed the appeal taken under 24a on the ground that no such appeal could be taken (78 Fed. (2d) 1118). Petitioners applied for

certiorari from both orders in case Nos. 375 and 376 and on October 14, 1935 this court granted certiorari (296 U. S. 565). Among the questions presented in the Petition for Certiorari was the following:

> "May a court take away capital from the first mortgage bondholders and give it to the mortgagor and the other junior interests,"

It was pointed out in the petition (p. 32) that the plan which exchanged the bonds for stock and gave a 10% interest to "Straus" for its junior interest on a parity with the superior interest when there was no equity for the junior interest, was unfair and inequitable. This court held (297 U. S. 160) that the appeal by NETTIE MEYER was improperly taken under 24a and was properly dismissed. It further held that the appeal from the order approving the Plan could only be taken under 24b, and inasmuch as the Seventh Circuit exercised its discretion to deny the appeal, it would not review its discretionary action because "the criticisms of the Plan are not of a character to invite the exercise of the discretion." *This view was later changed* by the decision in *Case* v. *Los Angeles Products Co.* (308 U. S. page 106).

After the discharge of the Debtor, petitioners again attempted to obtain a review of the merits of the Reorganization.* They asked leave to appeal under 24b and prosecuted an appeal under 24a.** The Seventh Circuit denied leave to appeal (90 Fed. (2d) 151) and dismissed the appeal taken under 24a on the theory that it had no jurisdiction to entertain that appeal (92 Fed. (2d) 778). A petition for Writ of Certiorari was again presented to this court which was denied on January 1, 1938 (302 U. S. 767). Thereafter, on May 19, 1938, petitioners filed a Second Amendment to their Complaint (R. 11), which

* On the former appeal (297 U. S. 160) this court held that the right to appeal under 24a accrues upon an entry of an order of discharge.

** The confusion on the method of appeal was remedied by the Chandler Act.

stated, among other things, that after the filing of the original Complaint, the District Court stated in its opinion that the proceedings will not be restrained insofar as they will not interfere with the *res* which was involved in the Reorganization; that the Reorganization is now completed and under the Plan the first mortgage bondholders were given 90% of the common stock and 10% was given to the junior interest, and because of the completion of the Reorganization Proceedings, all allegations pertaining thereto are eliminated from the Complaint, and in lieu of the relief prayed in the original Complaint the petitioners asked: (a) that the trustees be required to account for all moneys received and disbursed while they were in possession; (b) that individual members of the Committees be required to account for their acts and doings and be held liable for malfeasance; (c) that the trustees be held liable for misapplication of funds derived from the income of the premises in payment to "Straus" on defaulted bonds and coupons; (d) that all defendants be required to account for all moneys received and disbursed, and (e) that the court may ascertain the value of the new securities and hold the defendants liable for the damages caused by reason of their gross negligence and fraudulent acts (R. 12-13).

Defendants filed answers to the Complaint as Amended but on the day of the trial interposed an additional defense alleging that the 77B proceedings were a complete bar to this action (R. 23), to which the petitioners replied that the action in the Federal Court could not be pleaded in bar for the reason that the 77B proceedings involved proceedings *in rem* and not proceedings *in personam*, and for the further reason that the defendants, who pleaded that the proceedings in the Federal Court are a bar to this action, have taken the opposite position in the Federal Court that the proceeding could not be pleaded in bar (R. 23-25). The Appellate Court sustained this defense (308 Ill. App., p. 78).

ARGUMENT.

I.

IN SUSTAINING THE DEFENSE OF RES ADJUDICATA THE APPELLATE COURT DEPRIVED PETITIONERS OF THEIR CAUSE OF ACTION WITHOUT DUE PROCESS OF LAW IN VIOLATION OF THE FOURTEENTH AMENDMENT TO THE CONSTITUTION.

Petitioners were not parties to the federal proceeding. This was adjudicated by the Seventh Circuit (92 Fed. (2d) 778). The Federal Court was without jurisdiction of the action *in personam* for accounting against the trustees and the Committees. In sustaining the defense of *res adjudicata* the Appellate Court deprived petitioners of their cause of action without due process of law in violation of the Fourteenth Amendment to the Federal Constitution.

(a) A Defense of Res Adjudicata Based on a Proceeding Where the Court Had No Jurisdiction of the Parties and Subject Matter Cannot Be Sustained Without Violating the Fourteenth Amendment.

This court has held that a defense of *res adjudicata*, based on a cause of action where the court *lacked jurisdiction* of the parties or subject matter, *is in violation of the Fourteenth Amendment* (*Hansberry* v. *Lee*, 311 U. S. 32). The defense of *res adjudicata* was not sustained below and was sustained for the *first time* on appeal. This was raised by the petition for rehearing (see appendix) which was denied (R. 59).

(b) A Denial of Intervention Cannot Be Pleaded in Bar to an Independent Suit.

The cause, pleaded in bar to this suit, was appealed by the petitioners (*Meyer* v. *Kenmore-Granville Hotel*, 92 Fed. (2d) 778) on the theory that they were parties to the pro-

ceedings by intervention. The Circuit Court *dismissed the appeal* on the ground that they *were not parties to the proceedings.* It said that their status was that of **"attempted intervenors"** and that the dismissal of their petition "was in effect, **a denial of the right to intervene and to participate as parties to the proceedings."** *A denial of intervention cannot be pleaded as res adjudicata to an independent* suit. (*State of Washington* v. *United States,* 87 Fed. (2d) 421, 433; *Re Decatur,* 106 Fed. (2d) 30, 32; *Credit Commutation Co.* v. *U. S.,* 177 U. S. 311.) Its statement that it looked at the merits, is not an adjudication for the reason that after it reached the conclusion *that it was without jurisdiction of the appeal it had no right to decide the merits and its statement is a nullity* (*Chicago Portrait Co.* v. *Crayon,* 217 Ill. 200; *McDonald* v. *Worth,* 367 Ill. 529, 534). Besides, it might be that in considering the merits it sustained the position taken by the *appellees* there, *that the issues involved in the independent suit were not involved there* (R. 46).

(c) The Respondents Who Urged in the Federal Court That That Court Was Without Jurisdiction of the Subject Matter of the Accounting Were Estopped to Plead Res Adjudicata of the Action in the Federal Court.

In the brief filed on the appeal **respondents took the position** (R. 47) that the Federal Court **had no jurisdiction in the reorganization proceeding to adjudicate the issues involved in the accounting suit.** They cited authorities on the proposition. *They could not thereafter be heard to say that the court which had no jurisdiction of the subject matter has adjudicated the questions involved in this suit.* (*Dant & Russel* v. *Halsted Lumber Co.,* 103 Fed. (2) 306, 308; *Ass. Int. Corp.* v. *Scott,* 7 C. C. A., 103 Fed. (2) 209.) It must be assumed that they were correct, *as the law conclusively*

demonstrates that the Court in the 77B proceeding was without jurisdiction of the subject matter. (*Re* Adolph Gobel, 80 F. (a) 849; *Re* Prudence Bonu Corporation, 75 F. (2) 262) and *the authority cited by them* (R. 41) "Utilities Power and Light Corp." (91 F. (2) 598, 602.) Being without jurisdiction of the subject matter there could be no adjudication thereof *as an adjudication without jurisdiction is completely void.* (*Toma* v. *Park Castles Bldg. Corp.*, 375 Ill. 293.) The *respondents urged on the appeal* (R. 46):

> "The **alleged liability of the mortgage trustees and the bondholders' committees is not involved in this reorganization** proceeding."

They said (R. 47):

> "Appellants also have their cause of action pending in the state court in which they have prayed the same relief against mortgage trustees and the committees (Ex. 19, pp. 37, 65). *In re Utilities Power and Light Corporation*, (C. C. A. 7th) June 30, 1937, C. C. H. Bankruptcy Service (page 2578) the court said:
>
> > 'Sec. 77B contemplates the reorganization of the debtor. It was not intended to provide the forum to settle collateral issues between parties who may be interested in the debtor. **Suits may be brought on unliquidated claims by the debtor after the reorganization takes place.**' "

They were *estopped* to change their position (*Stevens* v. *Stevens*, 297 Ill. 338, 345).

II.

THE JUDGMENT OF THE APPELLATE COURT CAN ONLY BE SUPPORTED BY THE FEDERAL QUESTION.

The statement in the opinion that the court also considered the merits may be applicable to the causes of action which the Appellate Court considered on the merits:* (a) Liability of the trustees for the deposit of

* We will show under (b) that even as to these causes the decision is untenable.

the *net income* from 1925 to 1931 with "Straus"; (b) Liability of the trustees for the failure to inform bondholders of the existing defaults in order to afford them the opportunity to exercise their legal remedies, and (c) failure to prove loss by reason of the failure of the trustees to reveal the facts to the investors. **These are the only issues discussed in the Opinion on Merits.** The Appellate Court **did not consider on the merits, the additional causes:** (d) the general accounting from the trustees for the gross receipts and disbursements from the operation of the premises from 1925 to 1934; (e) the liability of the Committee members for their betrayal of trust duties in that, instead of protecting the investors whom they assumed to protect, they protected "Straus" by taking away 10 per cent of the mortgaged premises and giving it away to "Straus" without consideration, not seeking an accounting from the trustees, and failure to protect the interest of the investors pertaining to the guaranty of the bond issue. A reading of the Opinion will disclose that the Appellate Court did not consider the merits of these claims, and the affirmance of the dismissal of the proceedings for want of equity as to these claims, can only be based on the federal question, namely, the defense of *res adjudicata.*

(a) The Causes of Action Against the Trustees for Accounting and Against the Committees for Malfeasance Were Not Decided on the Merits But on the Federal Question.

A decision on a non-federal question must not be *untenable.* There is no theory of law under which it may be said that beneficiaries of a trust are not entitled to an accounting from their trustees. It cannot be said that the Appellate Court sustained the dismissal of the Complaint on the ground that beneficiaries are not entitled to such

relief. *The only theory upon which its decision may be predicated, is on the federal question, that the accounting was sought in the Federal Court, was denied, and was adjudicated.* This therefore squarely presents the federal question for review.

Suit Against Trustees For Accounting

The original Complaint charged (R. 3) that the trustees were in possession of the mortgaged premises from May 8, 1925 to August 14, 1934 and (R. 10) that the properties were grossly mismanaged and the trustees should be directed to account. In the Amendment to the Complaint filed after the completion of the Reorganization, it was expressly prayed (R. 12) that the two trustees be required *to account for all moneys received by them and disbursed from the date of their entry into possession up to the date when the federal proceedings were commenced.* At the trial of the case the defendants admitted the request for admission of certain facts (R. 31) that the two trustees entered into possession May 8, 1925 because of the default of the mortgagor and that they managed and operated the premises. Under such a set of facts no plausible theory can be found for the decision of the Appellate Court that the beneficiaries were not entitled to the accounting, except its decision that the matter had been adjudicated. *The issue on the general accounting was therefore decided on a federal question.* Petitioners are therefore entitled to invoke the jurisdiction of this court by Writ of Certiorari.

Suit Against Committees for Breach of Trust

The second cause of action is the liability of the committee members for their misfeasance and malfeasance. The decision on this cause must be held to have been based on the federal question involved. The Amended Complaint sought to hold the Protective Committees liable for their unfaithful trust to the

beneficiaries in promulgating and obtaining the approval of the Plan in violation of their duties. The original Complaint charged that after "Straus" acquired the mortgaged premises in the name of SIDNEY H. KAHN, it organized Protective Committees for the two buildings, one Committee was headed by SIDNEY H. KAHN (R. 4), and the other by SAMUEL J. T. STRAUS. In soliciting the securities for deposit with the Committees, it stated that *the property was acquired by "Straus" "to protect first mortgage bondholders on both properties"* and that the Committees were formed to *protect the interests of the bondholders.* In violation of the representations and duties, the "Straus" Committees adopted a Plan which would take away from the bond owners 10 per cent of the mortgaged premises as well as control by the scheme of a Voting Trust and placed it under the control of "Straus", the equity owner (R. 6). The Amendment to the Complaint subsequent to the confirmation of the Plan eliminated the prayer for relief to prevent this Plan (R. 12), but sought relief against the Committee members for its malfeasance and misfeasance in bringing about the approval of such a Plan by the court. The evidence in the case showed that the bond issue on the Annex contained a personal guaranty, which was never enforced by the protectors (R. 38).

The Decision on These Causes were Based on the Federal Question The decision of the Appellate Court in discussing the merits of the case *does not discuss the merits of the claim* against the members of the Committee and the general accounting from the trustees. It must be concluded that the denial of the relief for such claims was based on the federal question, the adjudication in the 77B proceeding. In *International Steel Co.* v. *Surety Co.,* 297 U. S. 657, the court said, page 666:

> "The rule that when a decision of a state court may rest upon a non-federal ground adequate to support

it, has no application where it appears from the decision that the non-federal question was not considered."

This court may examine the opinion to see whether the court rested its decision on a non-federal question adequate to support its judgment (*Indiana* v. *Brand*, 303 U. S. 9598). There is no possible tenable theory under which the decision denying the relief against the Committee members and the trustees could be based on a non-federal question.

The Liability Is Clear and the Denial of Relief Must Be Based on the Defense of Res Adjudicata

The evidence was undisputed and the liability is unquestionable. It should be noted that these Protective Committees were headed by the President and Vice-President of the "underwriter" company *which acquired the equity of redemption* and that the members of the Committee had a financial interest in the underwriter and stood in an adverse position. The statement of this court in *Wood* v. *City National Bank*, 312 U. S. 262, is well apropos here. There, this court said:

> "A committee was formed by the respondent trustee to represent the first mortgage bonds in the reorganization. It was composed of five members. Two of these were officers or employees of one of the principal underwriters of the bonds. *This underwriter was heavily interested in the equity.* So far as appears, the fact was not disclosed when the committee solicited the bondholders. In any event, *the equity owner is peculiarly ill-suited to represent the mortgagee in these situations because of their historic clash of interest.* See *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106." (Italics ours.)

"Straus" stated in its communication (R. 25) of January 24, 1931 that the equity was acquired **"without affecting the outstanding first mortgage"**. It stated that **it acquired**

the equity "to protect the first mortgage bondholders on both properties". The bondholders had the right to assume that these committees in performing their trust duties *would afford due protection and not take away 10 per cent from the mortgaged premises in favor of "Straus"*, which they did by their communication of January 13, 1933 (R. 37).* It is true they gave the bondholders the opportunity to withdraw, but the bondholders were required to pay 3 per cent for this privilege. They failed to take action against the guarantor of the bond issue. They failed to obtain an accounting from the trustees for the gross income and expenses during their tenure of office from 1925 to 1934. There is no plausible theory which may be advanced why beneficiaries were not entitled to such relief from their trustees. In *Wood* v. *City National Bank, supra*, 312 U. S. 262, this court pointed out that in that case "no effort was made" to assert any liability against the "underwriters" and it said:

> "Objective scrutiny and full enforcement of an underwriter's liability requires a committee freed from that underwriter's influence."

It pointed out that:

> "The committee had as its two most active members officers of the indenture trustee. It was in substance a part of the indenture trustee's reorganization division * * * Beyond that is the fact that an indenture trustee closely affiliated with the committee shares the committee's conflict of interest."

In the instant case *such an effort was made* and the only theory to base the denial of the relief is on the federal question.

---

* The fact that the court approved the plan because the committees claimed that the required number of the depositors consented to the plan by their failure to object does not deprive the petitioners or depositors who did object from suing their trustees for their betrayal of this trust in sponsoring the plan and in obtaining its approval.

(b) The Decision on the Merits Is Untenable and Does Not Adequately Support the Judgment.

While it is unnecessary for the purpose of invoking the jurisdiction to discuss the decision on the merits for the reason that to at least *two causes there was no decision on the merits,* yet we will also show that *the decision on the merits on other issues is also untenable* and cannot adequately support the judgment.

Exoneration of Trustees The opinion holds that trustees who entered into possession *after default by the mortgagor* had the right to remain in possession *for six years* without ever disclosing such facts to the beneficiaries and to deprive them of their rights and remedies (resulting in a loss of 92 per cent of their investment) and that *such trustees are not accountable for the income received during their stewardship and are not liable for loss caused to the investors.* Such a proposition is *untenable* (*Wood* v. *City National,* 312 U. S. p. 262). The exact proposition involving a similar Trust Deed was decided adversely in *Layman* v. *Stevens,* 123 Conn. 591 (1938). There the court said:

> "In such a case as this when a substantial default of the mortgagor occurred and the trustee, in the exercise of the powers given to it by the trust instrument, undertook to pay the coupons due from its own funds, honesty and fair dealing required that the trustees within a reasonable time should take steps to notify the bondholders of the default and of its action, that the bondholders might know what was happening to their security, and that they might have an opportunity to protect their own interests by application to the court as provided in the mortgage agreement. *Marshall* v. *Ilsley Bank & Guaranty Investment Co.,* 213 Wis. 415, 250 N. W. 862, 865; *First Trust Co. of Lincoln* v. *Carlsen,* 129 Neb. 118, 123, 261 N. W. 333; *Loud* v. *Winchester,* 52 Mich. 174, 183, 17 N. W. 784; 4 Bogert, Trusts & Trustees, Sec. 961. **We hold, therefore, that**

> **the Trustee in this case committed a breach of duty in failing to give reasonable notice to the bondholders of the default of the mortgagor and the payment from the Trustee's own funds of the interest coupons.** The trustee, consequently, **is chargeable with any loss or depreciation of value in the trust property resulting from the breach of duty.** Restatement, Trusts, vol. 1, Sec. 206, Comment 3." (Emphasis supplied.)

It is curious to note that the Wisconsin decisions upon which the Supreme Court of Connecticut relied were also relied on *by the same Appellate Court in Meyers* v. *American National Bank,* 277 Ill. App. 378, involving a "Straus" case and *the same principle of law.* The instant case is much stronger than the Connecticut case for there, the concealment was only for *two* years, while here it lasted *six* years.

Loss of 92 Per Cent Was Established In denying the relief for the loss of 92 per cent of the investment by reason of the failure of the Trustees to advise them that they were in possession (after default) during the six-year period, the opinion states that *the court took notice of the point* that foreclosure *might have resulted prior to 1931 if the facts were made known,* but the "theory" of the case was "unusual" and "novel" because *"the depression in the value of such properties during the period from 1925 to 1931 is too well known to need comment or discussion."* In taking *judicial notice* of the "depression" it overlooked that *the depression commenced in October, 1929 and that real estate was at its height prior thereto.* If foreclosure was had prior to 1929 the bondholders would have realized *the full amount of the investment.* The defendants who advanced the interest and principal during 1925 to 1930 *must have thought that the property was worth the amount of the Bond Issue* and the court pointed out that "Straus" wound up with an investment of $400,000 in such advances. "Straus" evidently

thought the investment was safe when it was made. It is evident that a foreclosure during these years would have brought the full amount of the debt even in December, 1929. This is demonstrated from the fact that shortly after the *commencement* of the depression "Straus" saw fit *to purchase the property,* subject to the continuing lien. *Thereby the defendants established the value of the property for the full amount of the bond issue when they purchased it at the partial foreclosure on December 19, 1929, subject to the continuing lien of the remainder of the bond issue.* By their purchase of the property subject to the continuing lien *they thereby established the measure of damages* (*Loeb* v. *Stern,* 198 Ill. 371, 383). Even if the measure of the damages was improper, a dismissal would not follow but a *retrial.*

Net Income Was Wrongfully Diverted

The opinion justifies the deposit of the net income with "Straus" on the ground that "the Trust Deeds gave specific authority to do this." *There was no provision in the Trust Indenture authorizing the Trustees to make deposits* with S. W. Straus & Co., *after the Trustees entered into possession.* On the contrary, *the authority was limited* (R. 38) *"to apply* the residue * * * ratably, *to the persons entitled thereto without discrimination or preference." The authority to make deposits was limited to the "mortgagor"* (R. 57). Powers of a Trustee are *strictly construed* against them. (*Chicago Title and Trust Company* v. *Robin,* 261 Ill. 161.) The Trust Indenture *is the charter of the powers* of the Trustees. (*Tudor* v. *Firebaugh,* 303 Ill. App. 452; *Chicago Title & Trust Co.* v. *Chief Wash Co.,* 368 Ill. 146, 153.) If the payment was made directly to the bondholders as required under the Trust Deed (R. 38) *they would have known as early as 1925 that defaults existed* and would have been in a position to demand payment, to *sue on the guaranty* (R. 38), *or to foreclose.* The medium of the deposit with "Straus" was

used for the purpose of "lulling the bondholders into the belief" that the bond issue was in good standing (*Myers* v. *American National Bank*, 277 Ill. App. 378) and *during the six-year period when the House of Issue advanced the funds it was able to remain in business and to sell bonds under its slogan as to the safety of its securities* (R. 32). *The Trustees breached their trust when they diverted the funds for such deposit in favor of their House.* The bondholders were prevented from the enforcement of their remedies which resulted in a loss of 92 per cent of their investment.

Maintenance of Market After Default

The opinion states:

> "The interest was paid pursuant to the provisions of the trust deed, the purpose of which was *to prevent a default* in the bonds *which would seriously impair their market value.*" (Italics ours.)

Whose "market value" did these payments maintain? *They maintained the market for "Straus" so that it could sell its securities under its "chain of safeguards"* with the slogan "Forty-Two Years Without Loss to any Investor" (R. 32). The very thought that Trustees and their "House" *may conceal defaults* in order to "maintain a market," and the *sanction* of such deception is unthinkable. If they prevented the impairment of the "market value" of the bonds during 1925 to 1931 and they had informed the petitioners of the existing defaults they would have disposed of their bonds in such market. Conceding for the sake of argument that "Straus" had the right to advance the interest and *conceal* such facts prior to May 8, 1925, in order not to "impair" the "market value" of the bonds under the hope that the defaults might be cured *it had no right to "purchase," without the knowledge of the bondholders, after the Trustees entered into possession and to maintain a market by the concealment of such facts.*

Adverse Interests Samuel J. T. Straus, President of S. W. Straus & Co. and Melvin L. Straus, its Vice-President were directors and financially interested in that corporation (R. 42), and *the Trustees of the two bond issues.* Their interest to protect the bondholders was adverse to their interest as officers of S. W. Straus & Co. If the investors were notified of the default, and "Straus" failed to pay, it could not have remained in business and to hold out to the investors the "safety of the security" and that no investor has ever lost anything on that House as it held out in its pamphlets and advertisement (R. 32). *For that purpose it was necessary for the House to cash the bonds and coupons as they matured.* (*Wood* v. *Guaranty Trust,* 128 U. S. 416.) After cashing such coupons and bonds, it next became the *personal* interest of the Trustees to use the income collected thereafter to reimburse *their* House. In one instance bonds and coupons which matured in 1925 and were cashed by the House were paid out of funds deposited by the Trustees *a year later.* In many instances the funds were deposited *subsequent to three months after the default day* (R. 39).

Because of such violation of trust duties the House had a *subordinate position* on the funds advanced, under the doctrine that "this solitary rule will remove the strong temptation to trustees to act for their advantage to the detriment of the *cestui que trustent.*" The point made by the Appellate Court that the Trust Deed sanctioned such advancement is unsound as such advancement was only *authorized prior to the entry in possession by the Trustees.* The provisions are to be construed most strongly against the Trustees. It was the intention that as long as the mortgagor was in possession and there was hope to cure the defaults that such "purchase" might be made. There was no such intention *after condition broken and entry.*

The opinion said (308 Ill. App. 78, 82) that the decision of this court in *Pepper* v. *Litton,* 308 U. S. 295, was

inapplicable. There, this court pointed out that the doctrine of subordination is founded on *"the violation of rules of fair play and good conscience"* or "a breach of fiduciary standards of conduct."

Each and every principle announced by this court *was ignored in the instant case.* The purchase of the property under the junior foreclosure in the name of Sidney Kahn was admitted to have actually been for the use and benefit of S. W. Straus & Co. *wherein the two Trustees were the chief officers and directors. The Trustees could not act as trustees and at the same time own the property,* as said in *Wood* v. *City National Bank,* 312 U. S. p. 262), *"the equity owner is peculiarly ill-suited to represent the mortgagee in these situations because of their historic clash."* The scheme to own it in the name of Kahn or in the name of the corporate entity is no shield. *They have used their office of trust to help themselves through the agency of their corporate entity, to the detriment of the investors, which cannot be tolerated by a court of equity.* (*Pepper* v. *Litton, supra.*) In the *Pepper* case (which the opinion says is not in point) it was also said (p. 312):

> "No matter *how technically legal each step in that scheme may have been,* once its basic nature was uncovered *it was the duty* of the bankruptcy court *in the exercise of its equity* jurisdiction *to undo it.* Otherwise, the fiduciary duties of dominant or management stockholders would go for naught; *exploitation would become a substitute for justice; and equity would be perverted* as an instrument for approving what it was designed to thwart." (Italics ours.)

In *Wood* v. *Guarantee Trust & Safe Deposit Co.,* 128 U. S. 416, this court said:

> *"Its advancing of interest to its customers is to be attributed to a desire on its part to preserve an unimpaired market for its mortgage bonds,* rather than to a desire to confer a boon upon them by purchasing their interest coupons." (Italics ours.)

The two trustees *kept the "pathway open" from* 1915 to 1931 so that their House might advertise:

> "Every possible precaution is taken during the life of these securities to maintain them in the same attractive position in which they were when offered to the public."

and to invite the investors to "clip all coupons" and "mail them" and they would be cashed without "any unnecessary trouble" (R. 32-33).

The default occurred immediately upon the construction of the building, resulting in the *secret entry into possession by the two trustees on May 8, 1925.* Not a word was said to the investors up to January, 1931! *They were "lulled into the belief" that everything was well.* (*Myers* v. *American National Bank*, 277 Ill. App. 378.)

Right to Relief The last paragraph in the opinion states:

> "The holders of the comparatively small amount of these securities by much litigation have given to their bonds an unusual nuisance value."

The 19 bonds which were purchased by the plaintiffs at par from "Straus" might have taken all the money these investors had to invest. *To them the loss of 92 per cent of* their investment on these 19 bonds is of great value, and to say that because the plaintiffs are comparatively few they are not entitled to the relief is to overlook that equity is guided by justice and not by the dollar sign. This court in *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, had this to say upon a similar contention:

> "In this case the fact that 92.81 per cent in amount of the bonds, 99.75 per cent of the Class A Stock and 90 per cent of the Class B Stock have approved the Plan, it is immaterial on the basic issue of its fairness as is the fact that petitioners only have $18,500 face amount of the large bond issue."

The rights of a single creditor are as sacred as the rights of the many and deserve the protection of a Court (*In re*

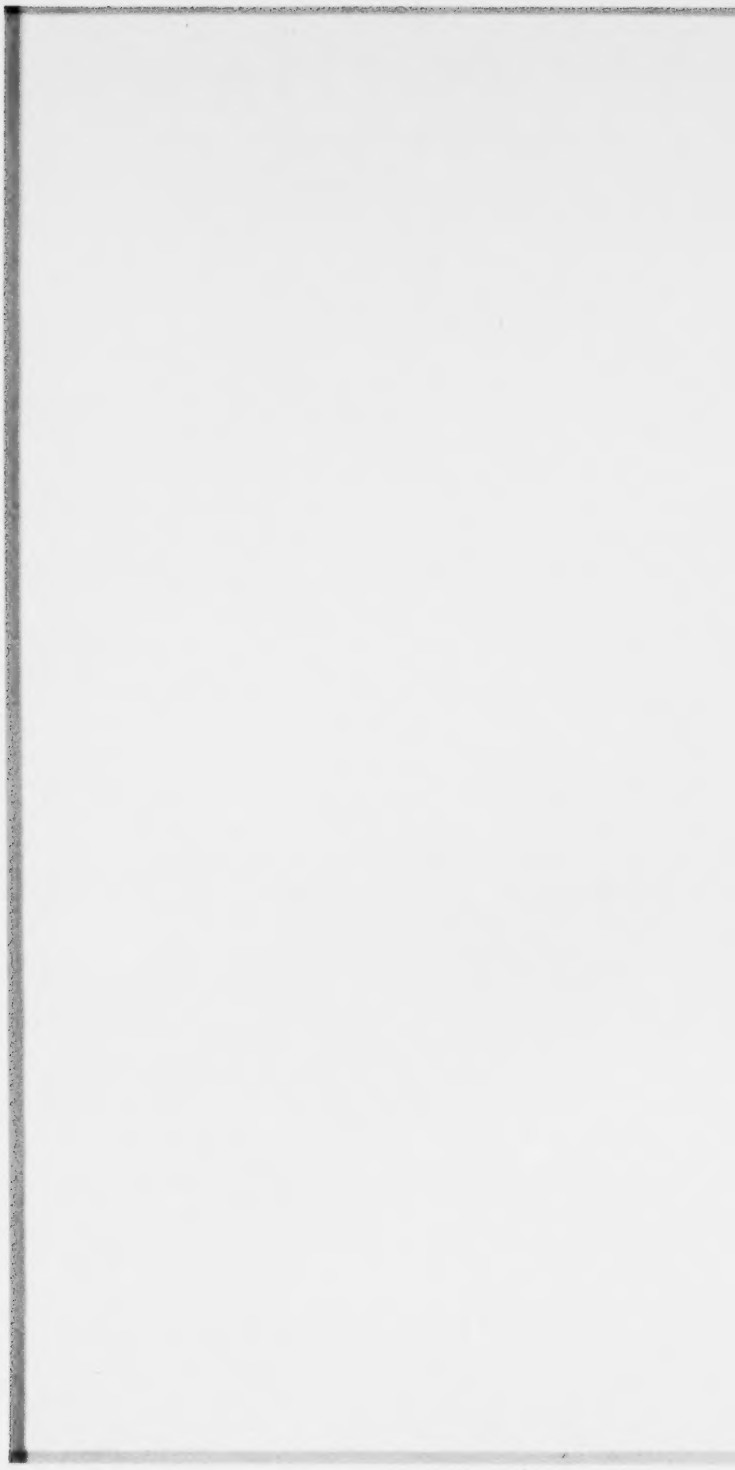
Phila. & Reading Coal & Iron Co., 3 Cir. 105 F. (2) 357). Besides, the doctrine advanced by some of the courts for the purpose of defeating the intereset of the small investors that their interest is "a nuisance value" has been used in connection with reorganization schemes where it may be said that the small minority in opposing reorganization is trying to obtain a nuisance value. *It does not apply to this case where no attack is made to upset the reorganization Plan but to simply hold the defendants liable in damages for their breach of trust, bad faith and the loss caused to the extent of 92 per cent of the investments.* **The substantive law affords no warrant for the abridgement of the rights of the smallest investor.** (*First National Bank* v. *Flershem*, 290 U. S. 504.)

We hope that this court will give *real value* to the distressed bondholders and disregard the "nuisance value" theory by the allowance of the Writ of Certiorari.

Respectfully submitted,

MEYER ABRAMS,
Attorney for Petitioners.

SHULMAN, SHULMAN & ABRAMS,
134 N. La Salle Street,
Chicago, Illinois.



APPENDIX.

The petition for rehearing filed in the Appellate Court on February 5, 1941 (R. 59) contained among other things the following:

"*Res Adjudicata:*

On the question of *res adjudicata* it should be noted that *this defense was not sustained by the trial court.* A dismissal of a complaint for want of equity does not embrace a plea of *res adjudicata.* The reason why the lower court did not sustain it is apparent from the position taken by the defendants in the United States Circuit Court of Appeals where *they contended that the proceedings there can under no sense be pleaded as res adjudicata to the accounting against the trustees* (Abst. 46, 47). The entire argument in our brief (pp. 35-45) on the question of *res adjudicata was wholly overlooked* by this court. In sustaining the plea of *res adjudicata* this court deprived the plaintiffs of their property without due process of law in contravention of the Fifth and Fourteenth Amendments to the Federal Constitution. (*Cumberland Glass Co.* v. *DeWitt,* 237 U. S. 447; *Hansberry* v. *Lee,* 85 L. Ed. p. 11.)"